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Accountants & Advisors

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Memorandum

To	AASB
From	Hayley Underwood
Date	5 November 2021
Subject	Post Implementation Review of IFRS 9 – ShineWing response

We are pleased to provide our feedback as part of the post-implementation review of IFRS 9 *Classification and measurement of financial assets* undertaken by IASB.

Question 1: Classification and measurement

Do the classification and measurement requirements in IFRS 9:

a. enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them? Why or why not?

b. result in an entity providing useful information to the users of the financial statements about the amount, timing and uncertainty of future cash flows? Why or why not?

Response

In principle we agree the changes brought in by IFRS 9 in a manner that their measurement aligns with cash flow characteristics help users understand the liquidity position of an entity better than other measures permitted by IAS 39. Also, they reflect well the focus of management in deploying the financial resources of the entity.

Linking the classification to cash flow characteristic enables management as well as users appreciate the timing and uncertainty of cash flows associated with a financial asset or a group of financial assets. For e.g., the understanding that emerges from a classification of debt instruments at FVOCI is that the degree of uncertainty associated with their cash flows is more than those measured at amortised cost; reason being the former classified instruments are more impacted by market dynamics due to relatively more turnover.

Question 2: Business model for managing financial assets

a. Is the business model assessment working as the Board intended? Why or why not? Please explain whether requiring entities to classify and measure financial assets based on the business model assessment achieves the Board's objective of entities providing users of financial statements with useful information about how an entity manages its financial assets to generate cash flows.

b. Can the business model assessment be applied consistently? Why or why not? Please explain whether the distinction between the different business models in IFRS 9 is clear and whether the application guidance on the evidence an entity considers in determining the business model is sufficient. If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

c. Are there any unexpected effects arising from the business model assessment? How significant are these effects? Please explain the costs and benefits of the business model assessment, considering any financial reporting or operational effects for preparers of financial statements, users of financial statements, auditors or regulators.

Response

Consistent with our response to question (1) above, our general view is that the business model assessment is useful in providing better transparency regarding the nature of financial assets held and reflects on management's strategy regarding use of economic resources. Further, the business model specified for arriving at the measurement attributes in the standard are, in our view, sufficiently distinct and clear.

However, as auditors we face challenges in our professional judgment due to lack of sufficient guidance in certain areas. In our view the business model assessment could be more effectively implemented by elaborating on the following couple of areas in the standard:

- Specifying a timeframe over which the business model has to be examined for assets that have been newly purchased or originated assets. Paragraph B4.1.2A requires looking for past & other relevant information but it is particularly difficult for financial assets that have entirely new terms and conditions and purposes than those that were held in the past. For such entirely new financial assets, an observatory period can be allowed for entities to study their evolving business model and then adopt the appropriate measurement attribute. For this purpose, the initial classification may by default be regarded as financial asset at fair value through profit or loss. Any change in measurement attribute due to the subsequently determined business model may be accounted as per the provisions regarding reclassification in IFRS 9.
- Paragraph B4.1.2 may pose some risks for entities in terms of potential misstatement in a particular situation. It states "*The entity's business model does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation*". If a new financial asset is being issued of very high value and reflects different management intention than the portfolio to which it belongs, then it could lead to different business model assessment than how the entity actually manages that high value asset in practice. The difference between amounts that would have been recognised in a portfolio level and instrument level assessment of such financial assets may potentially to be a material misstatement in the statement of financial position. Hence there must be some relaxations from this general rule to adopt a suitable measurement attribute for such high value financial asset and require sufficient disclosures to the effect.

Question 3: Contractual cash flow characteristics

a. Is the cash flow characteristics assessment working as the Board intended? Why or why not? Please explain whether requiring entities to classify and measure a financial asset considering the asset's cash flow characteristics achieves the Board's objective of entities providing users of financial statements with useful information about the amount, timing and uncertainty of future cash flows. If, in your view, useful information could be provided about a financial asset with cash flows that are not SPPI applying IFRS 9 (that is, an asset that is required to be measured at fair value through profit or loss applying IFRS 9) by applying a different measurement approach (that is, using amortised cost or fair value through OCI) please explain: (i) why the asset is required to be measured at fair value through profit or loss (that is, why, applying IFRS 9, the entity concludes that the asset has cash flows that are not SPPI). (ii) which measurement approach you think could provide useful information about the asset and why, including an explanation of how that approach would apply. For example, please explain how you would apply the amortised cost measurement requirements to the asset (in particular, if cash flows are subject to variability other than credit risk). (See Section 7 for more questions about applying the effective interest method.)

b. Can the cash flow characteristics assessment be applied consistently? Why or why not? Please explain whether the requirements are clear and comprehensive enough to enable the assessment to be applied in a consistent manner to all financial assets within the scope of IFRS 9 (including financial assets with new product features such as sustainability-linked features). If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

c. Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects? Please explain the costs and benefits of the contractual cash flow assessment, considering any financial reporting effects or operational effects for preparers of financial statements, users of financial statements, auditors or regulators. In responding to (a)–(c), please include information about financial instruments with sustainability-linked features (see Spotlight 3.1) and contractually linked instruments (see Spotlight 3.2).

Response

Cash flow characteristics should indeed be one of the driving factors in assessment of the appropriate measurement attribute for a financial asset alongside the business model assessment. There are however areas where issues may potentially arise:

The additional guidance provided in paragraph B4.1.11 does not align with paragraph 6.57 of the conceptual framework (CF) which states "*Amortised cost is unlikely to provide relevant information about cash flows that depend on factors other than principal and interest.*" Paragraph B4.1.7A defines interest to include consideration for time value of money, credit risk and consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement.

Question 3: Contractual cash flow characteristics

Response

We suspect the cash flow characteristic assessment may not be as effective as intended due to inclusion of reasonable compensation for early termination or extension of contract. Paragraph B4.1.1(b) states that a prepayment amount consisting of principal and interest may include an amount of reasonable compensation for early termination and yet comply with SPPI criterion. Compensations exist in various forms such as break fee, fixed penalty, lost profits etc. Technically, break fee is a compensatory interest and can be regarded as compliant for SPPI assessment. But in other forms of compensation, there may be practical difficulty in assessing what is reasonable amount. At present, leading professional publications suggest benchmarking with market standard terms and conditions, legal limits & restrictions etc. We do realise there are limitations in providing guidance on what a reasonable amount is. But it is apparent that factors in addition to principal and interest come to fore if the amounts are significant and distort the underlying principle laid out in the CF. The same logic applies to a compensation for extension of a contract.

Question 4: Equity instruments and other comprehensive income

a. Is the option to present fair value changes on investments in equity instruments in OCI working as the Board intended? Why or why not? Please explain whether the information about investments in equity instruments prepared applying IFRS 9 is useful to users of financial statements (considering both (i) equity instruments measured at fair value through profit and loss; and (ii) equity instruments to which the OCI presentation option has been applied). For equity instruments to which the OCI presentation option has been applied, please explain whether information about those investments is useful considering the types of investments for which the Board intended the option to apply, the prohibition from recycling gains and losses on disposal and the disclosures required by IFRS 7.

b. For what equity instruments do entities elect to present fair value changes in OCI? Please explain the characteristics of these equity instruments, an entity's reason for choosing to use the option for those instruments, and what proportion of the entity's equity investment portfolio comprises those instruments.

c. Are there any unexpected effects arising from the option to present fair value changes on investments in equity instruments in OCI? How significant are these effects? Please explain whether the requirements introduced by IFRS 9 had any effects on entities' investment decisions. If yes, why, how and to what extent? Please provide any available evidence supporting your response which will enable the Board to understand the context and significance of the effects.

Response

While we appreciate the fact that the FVOCI option for equity instruments is useful for the users of financial statements to distinguish the holding intentions, we would like to share our views on a couple of the following areas:

- The FVOCI option is available if, inter-alia, the equity instrument is 'held for trading'. The term 'held for trading' has been aptly defined in the standard. However, the use of the words 'near term' could potentially cause issues in availing the option. This is a rather new term that is not being defined in any IFRS standard. In our view, the definition will be equally effective without these words as it clarifies that these instruments are not held of speculation and profit taking. The essence of FVOCI election is to distinguish management's intention of holding that equity instrument for strategic reasons of various kinds rather than fair value gains. Hence the timeframe really should not be a significant factor in the context. There is a likelihood of an entity misinterpreting the term and wrongly availing the option for e.g., on the impression that their profit taking is not intended in the 'near term' but based on a long-term certain event that will increase market prices. Such areas would pose difficulty for auditors and increase the cost of auditing due to potential disagreements.
- The unintended consequence of the above is that an entity could derive fair value gains as expected and yet not recycle the gains to PL when the instrument is disposed of (due to paragraph B5.7.1). We do realise that any attempt to define a timeframe for the words 'near term' will only bring in more rigidity in implementation. Hence, we request considering elimination of the words 'near term' from the definition of 'held for trading'. But if the Board does prefer to retain an indicative time horizon, then it would be ideal to amend it as 'short term' so that it is consistent with the term 'short-term profit taking' used in the next line of the definition. This is also a term that the professionals and preparers of financial statements have, over time, got accustomed by now.
- We suspect that the option to designate equity instruments at FVOCI is not entirely working due to the fact that a lot of entities still measure their unlisted equity instruments at cost as a proxy for fair value (as permitted by paragraph B5.2.3). The reasons are commonly cited as lack of sufficient and reliable information and possibly wide range of fair value estimates. Even if in subsequent periods, one of the indicators in paragraph B5.2.4 arise, the fact stays that there is not enough reliable information available yet, since the type of inputs used for fair value are still unverifiable. This might compel auditors to accept unreliable fair value measurements or cause disagreements with auditees due to paragraph B5.2.5 compelling fair value measurement thereafter for such equity instruments. So, this does not seem to bring about an effective change from the erstwhile IAS 39.

Question 5, 6 and 8:

Response

We generally believe these areas have been adequately addressed in the standard. No practical difficulties have been experienced by us in encountering these aspects. Hence, we do not have specific comments.

Question 7: Amortised cost and the effective interest method

a. Is the effective interest method working as the Board intended? Why or why not? Please explain whether applying the requirements results in useful information for users of financial statements about the amount, timing and uncertainty of future cash flows of the financial instruments that are measured applying the effective interest method.

b. Can the effective interest method be applied consistently? Why or why not? Please explain the types of changes in contractual cash flows for which entities apply paragraph B5.4.5 of IFRS 9 or paragraph B5.4.6 of IFRS 9 (the 'catch-up adjustment') and whether there is diversity in practice in determining when those paragraphs apply. Please also explain the line item in profit or loss in which the catch-up adjustments are presented and how significant these adjustments typically are. If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements. In responding to questions (a)–(b), please include information about interest rates subject to conditions and estimating future cash flows (see Spotlight 7).

Response

We appreciate the initiative of the board in requiring the amortised cost measurement using effective interest rate method for SPPI cash flow characteristics since it certainly adds the required dynamism to the historic cost convention. As laid out in the conceptual framework, amortised cost depicts the correct degree of uncertainty and timing related to the underlying cash flows of the instrument. However, we believe the effective interest rate method may not as effective as expected in case of financial instruments that have interest rates not aligned with market terms (more so involving related parties).

Paragraph 5.1.1 requires all financial assets/financial liabilities to be initially recognised at their fair value. Such non-aligned instruments are predominantly fair valued using level 3 inputs. In many circumstances the fair value is an expected value determined from multiple scenarios amidst lack of any precedent information and convoluted terms and conditions. A common practice for many entities has been to refer to a market interest rate corresponding to the amount and tenure of the financial instrument and then discount the maturity amount to its present value which is presented as the fair value. Due to lack of information, they are hesitant to cause unverifiable adjustments to the benchmarked discount rate to reflect difference in terms and conditions. As a result, the interest expense/interest income recognised in profit or loss is not entirely verifiable.

Question 9: Other matters

a. Are there any further matters that you think the Board should examine as part of the post-implementation review of the classification and measurement requirements in IFRS 9? If yes, what are those matters and why should they be examined? Please explain why those matters should be considered in the context of the purpose of the post-implementation review, and the pervasiveness of any matter raised. Please provide examples and supporting evidence when relevant.

b. Considering the Board's approach to developing IFRS 9 in general, do you have any views on lessons learned that could provide helpful input to the Board's future standard-setting projects?

Response

We would like to take this opportunity to highlight some issues with respect to accounting treatment of dividends received on investment in equity instruments as per paragraph B5.7.1. It prohibits recognition in profit or loss if the dividend *clearly represents a recovery of part of the cost of the investment*. In course of our interaction with client, we encountered the following difficulties in rationalising the conclusion:

- The term 'cost' has not been defined anywhere in the standard (the same has been defined in another standard i.e., IAS 16). The issue here is that paragraph 5.1.1 requires initial recognition of all financial assets at their fair value (with or without adjustment of transaction costs). Fair value, as we understand, is a product of application of IFRS 13 and does not always yield an amount that is equal to the cost of acquisition; the standard already addresses the accounting treatment for any difference between transaction price and fair value (paragraph B5.1.1-B5.1.2A). So, the logic is not quite clear in using an alien measurement attribute in this particular context. Unfortunately, this particular topic has not been well deliberated either in the board's meetings or professional views being published.
- The context in which this provision should be operative is not clear. The widespread understanding is that this applies to dividends received from pre-acquisition profits which is more apparent. But we believe it should be possible to afford an extended interpretation to the phrase '*recovery of part of cost of investment*' to cover a situation of winding up. In our view, given lack of clarity what 'cost' means in the context, there is a possible interpretation as recovery of fair value of the investment on the date of dividend. In such situations, this phrase can also apply to distributions received in course of winding up of the investee. The intention there is clearly to recover the investment (whether it's the cost or fair value). We therefore request clarification on this.
- Adopting a narrow interpretation to this phrase also introduces bias in accounting outcome arising on de-recognition of an investment in equity instrument that is measured at fair value through OCI. In an instance of winding up of an investee, the investor recognises all distributions as dividend income (as per paragraph B5.7.1) and adjusts the fair value reserve to bring down the investment's carrying amount to its fair value based on remaining net assets of the investee after the said distribution. The amount of income recognised is too large in value. We believe this outcome is not aligned with a scenario where the same instrument is transferred to a third party; in which case only the difference between the carrying amount and consideration received is recognised in profit or loss. The outcome may be aligned in case of the following financial assets in a winding up scenario:

Question 9: Other matters

Response

i. equity instrument whose fair value gains or losses are recognised in profit or loss. In such cases the decrease in fair value of the investment recognised in profit or loss after the distribution received is offset by income from distributions.

ii. For an investment in a subsidiary/JV/Associate, paragraph 12 of IAS 27 does require recognising dividends in the profit or loss of separate financial statements. But if the investment is accounted at cost as permitted by paragraph 10 of IAS 27, then the entity would potentially recognise an impairment in profit or loss (considering the indicator regarding dividend in IAS 36 – paragraph 12(h)).

Thus, there is only a net impact in profit or loss in these two aforesaid scenarios. It does not therefore look logical if the accounting outcome that emerges by not applying paragraph B5.7.1 to a winding up is different when compared to other scenarios.

We therefore request that examples be added to determine those dividends that are not to be recognised in profit or loss and in doing so consider giving wider interpretation to cover additional scenarios as discussed above.

As the situation stands, IASB had already settled that puttable-instruments accounted as equity as per IAS 32 (paragraphs 16A-16B) are not to be regarded as investment in equity instruments for the purpose of exercise of FVOCI option (IFRIC interpretation May 2017). But paragraph B5.7.1 is applicable only to investments in equity instruments that are not puttable financial instruments. We believe there is a need to bring consistency in dividend accounting by extending the entire requirement in paragraph B5.7.1 to distributions from puttable financial instruments that are accounted as equity. Even the distributions from such instruments are required to be presented as dividends.